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The Economy
THE OUTLOOK:

THE OUTLOOK: Could Overseas Financing Hurt the U.S.?

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AS THE U.S. has grown ever reliant on foreign central banks to finance its trade and budget deficits, the question arises: Could foreign governments, like China's, one day use this clout to influence U.S. foreign policy? Most experts say it's far-fetched. But some look at history and the state of modern markets and are worried.

"There is surely something odd about the world's greatest power being the world's greatest debtor," Lawrence Summers, Harvard University president and former U.S. Treasury secretary, said in a recent speech. He calls it "troubling" that the U.S. depends so much on "inevitably political" entities to finance its foreign debts.

Last year, the U.S. ran a $542 billion deficit in its current account -- the balance of goods and services between the U.S. and the rest of the world -- which had to be financed by selling stocks, bonds, and other assets to foreigners. The U.S. has run such deficits for years, but most of the time they were financed by private investors and their purchases were seen as a sign of confidence in the U.S. economy. But in recent years, private inflows haven't kept pace with the growth in the current-account deficit and foreign central banks have stepped into the breach, buying more than $200 billion of U.S. assets, mostly Treasury bonds and bills, last year. They do this to hold the dollar's value up against their own currencies, which makes their exports more competitive.

Foreign central banks, led by China's and Japan's, now hold close to $1 trillion of Treasury bonds and bills, almost a quarter of publicly held U.S. debt. That serves their economic interest, but it also gives them a potential financial lever.

IMAGINE A standoff between the U.S. and China over Taiwanese independence. What would happen if China stopped buying U.S. bonds, or sold them outright? As bond prices fell, their yields, which move in the opposite direction, would rise. Mortgage rates would rise, depressing home sales and weakening the economy.

How vulnerable is the U.S.? Not very, argues Federal Reserve Chairman Alan Greenspan. Although foreign central bank holdings are large, he says, they are small compared with the total trading volume in U.S. debt markets. Furthermore, most of their holdings are short-term bonds whose yields, unlike those on 10-year bonds, tend to be influenced more by the Fed's monetary policy than day-to-day buying and selling.

Still, if central banks stopped buying, someone would have to make up for the loss. Bond prices fell in mid-March on reports that Japan might stop buying dollars to hold down the yen. There are also instances of foreign buying and selling aggravating movements in U.S. bonds. Last summer's run-up in yields, usually blamed on fumbled communication by the Fed about deflation, may have begun when Japanese investors sold Treasurys to make up for losses in the Japanese bond market.

Economists argue that nations wouldn't want to destabilize U.S. markets because they would be hurt. If China stopped buying dollars, its currency would rise, hurting exports. China's leaders "hear from exporters who don't want to have a revalued currency because it might cut into their export sales," says Nicholas Lardy, a China expert at the Institute for International Economics. "They are very concerned about political stability, which they think is a function of job growth."

Economic history shows a number of times when countries subordinated economic interests to political goals. In both 1967 and 1973, Arab countries embargoed oil deliveries to the U.S. because of its support of Israel, even though the action deprived them of revenue (though in 1973 that was initially compensated by the simultaneous leap in oil prices) and by ultimately encouraging the West to become more energy efficient and to develop alternative supplies.

Nor is there anything new about countries using financial clout to further geopolitical goals. The U.S. took that route during the Suez crisis in 1956, notes former Clinton aide Rahm Emanuel, now an Illinois congressman. To force Great Britain and France to remove troops from Egypt, the U.S. refused to supply them with emergency oil supplies and blocked the International Monetary Fund from helping Britain defend its currency. Now, Rep. Emanuel worries, the U.S. has given China "veto power over our economic and security independence."

Unfortunately, the U.S. dependence on foreign lenders has become woven into the structure of its economy. It requires either much stronger foreign demand for U.S. exports or much weaker U.S. demand for imports -- neither of which is likely. A weaker dollar will help, but the depreciation to date is likely far from adequate. The IMF has another idea: a faster reduction in the budget deficit than the Bush administration contemplates. That would reduce U.S. demand for foreign savings and insulate it from the moods of foreign investors -- political or otherwise.